

Can America Stay on Top?

Paul Krugman

The United States has long enjoyed a unique position of economic supremacy. Not only is it far and away the most populous of the advanced market economies; for most of the past century it has also had substantially higher per capita income than any other major nation. As a result, the only puzzle about the Pax Americana that took shape in the 1940s is that it took so long in coming: at the time the United States actually took on the mantle of world leadership, it had about as much purchasing power as all other market economies combined.

By the early 1990s, however, almost everyone believed that the age of U.S. supremacy was nearing its end. U.S. GDP per capita was no longer exceptional when measured at current exchange rates, although when measured at purchasing power parity instead the United States still led its rivals in real output per head. Perhaps more significant, other advanced countries had clearly overtaken U.S. productivity in some industries, and surpassed the United States in some technologies. The rapid growth of Asian developing countries further suggested that the balance of world economic power might be shifting away from the original advanced nations; probably nobody now alive will see China come anywhere close to U.S. income per capita, but all it has to do is reach one-fifth of the U.S. level to become the world's largest economy in absolute terms. While prophets of "declinism" like Kennedy (1989) and Thurow (1992) did not entirely dominate the discourse—Nye (1992), for example, argued that despite its gradual relative economic decline the United States retained the resources to remain the world's political leader for decades to come—circa 1992 few people would have dared to suggest that a *second* "American century" might be in prospect.

At the millennium, however, such suggestions are indeed being made (for

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example, Zuckerman, 1998). Several years of extremely favorable U.S. economic performance, all the more dramatic in contrast to some of the crises and setbacks elsewhere, have made it seem possible that American supremacy, far from being further eroded, will return to something like its early post-World War II levels.

But can America really stay on top? To raise this question is not in any sense to accept the idea that the world economy is a zero-sum game; if America does well, this is not bad news for the rest of the world, nor is a renewed supremacy based on dismal performance elsewhere good for us. But it is still interesting to ask whether the special position of the United States in the world economy has gained a new lease on life.

America's New Economy

Around 1994, some businessmen and business economists began propounding what came to be known as the New Paradigm. As usually stated, this doctrine rejected the old idea that the risk of inflation would limit the possibilities for economic expansion. The doctrine's advocates claimed that a combination of rapid productivity growth—much more rapid than official measures indicated—and the increased competition due to globalization would mean that even a sustained expansion at very high growth rates would not cause any inflationary pressures.

Academic economists, myself included, were quick to notice that at least as stated this doctrine made no sense. Since productivity and actual production are calculated using the same data, any understatement of true productivity growth did not offer any room for faster *measured* economic growth. Moreover, international prices can just as easily feed inflation as prevent it; or to put it differently, globalization or no globalization, measured GDP cannot grow faster than the sum of employment and measured productivity increase.

But there is a twist in the story: however much their analytical arguments may have been logical nonsense, the new paradigmatics have reason to feel vindicated by events. Over the last few years the U.S. economy has indeed grown much faster than conventional estimates of its potential, with (at least by mid-1999) still little sign of serious inflation.

What seems to have happened is this: the new paradigmatics were correct in sensing that something important had changed for the better. They were unable to express that sense in a way that hung together logically, and economists were right to point that out; but perhaps we should have asked more carefully whether there was some reason why a new optimism had emerged among people closer to actual business experience. In any case, what now seems clear is that two important things have gone right for the U.S. economy. Productivity growth—as measured, never mind the dispute over unmeasured components—has accelerated, perhaps from the 1 percent per annum norm of recent decades to 2 percent or more (although some of this acceleration is due to changes in the way the numbers are calculated—and in any case three years do not a sustained trend make). In addition, the labor

market has become much less inflation-prone, with wage increases still modest despite 25-year lows in unemployment.

It is less clear why these good things have happened. Productivity growth has presumably accelerated because of information technology; but promises about the rewards of such technology have been repeatedly disappointed over the past decade. Why are they finally being fulfilled now? An amateur, non-technologist's guess is that connectivity pays off in a way that mere information processing does not: that replacing carbon-copy memos with publication-quality, laser-printed reports did not add much value, but that using the Internet to route trucks to the right place does. (My own experience is that personal computing had only a modest effect on my ability to generate and disseminate misinformation, but that e-mail and the Internet have made a big difference.)

As for the labor market, the quiescence of wages remains a considerable puzzle. A number of hypotheses, ranging from the aging of the workforce to increased competition among firms, have been proposed; but serious research, like that of Katz and Krueger (1999), suggests that these hypotheses are not adequate to explain why such low unemployment produces so little in the way of wage increase.

The upshot of the favorable news about the U.S. economy is this: whereas in 1995 a conventional view would have put the rate of growth of U.S. potential output at slightly more than 2 percent, and estimated the natural rate of unemployment at not much less than 6 percent, it now seems plausible that the rate of potential growth is around 3 and the natural rate below 5. If this good news is sustained, then, by 2005 America's potential output will be something like 12 percent higher than we would previously have guessed; by 2015 it will be 20–25 percent higher than we might have projected only a few years ago.

These numbers are significant but not earth-shattering—not enough, in themselves, to change one's view of America's future role dramatically. But the good news about the U.S. economy has been accompanied by bad news about potential economic or political rivals.

Asian Drama, European Anticlimax

Bad news, when it comes, tends to be more dramatic than good news. If America's current and prospective position in international league tables suddenly looks better than expected, this owes more to the disappointments of other countries than to the acceleration in our own growth.

Only a decade ago, Asia seemed to pose a challenge to both aspects of U.S. economic leadership. Remember that the United States has traditionally been both the biggest economy in absolute terms and the richest large nation per capita. At the beginning of the 1990s it seemed quite likely that it would soon have neither distinction: that within two decades the richest and the biggest economies would both be Asian.

On one side, Japan seemed likely to acquire the title of richest major economy. With only half of the U.S. population, even a highly productive Japan would have a hard time displacing the U.S. as the world's largest economy in absolute terms; but by 1990, Japanese labor productivity was closing in on U.S. levels, and its rate of growth was considerably faster. Thus, it seemed quite possible that by the turn of the millennium Japan would overtake the United States in per capita income (even adjusted for price levels). On the other side, China looked like a serious challenger in terms of absolute weight. If you believed estimates that put Chinese real GDP at 40 percent of U.S. levels as early as 1990, and supposed that China's economy could continue to grow at 7 percent or more while the U.S. economy grew at 2.5 percent or less, it became apparent that the United States could be put into second place as early as 2010 or so.

Well, the millennium is upon us, and Japan's economy has not overtaken that of the United States—indeed, Japan's economy has hardly grown at all since 1991. While China has thus far been spared the worst of the financial crisis that overtook its east Asian neighbors in 1997, in the light of that crisis few people now have the same optimism about China's prospects that was nearly universal a few years ago.

But one has to be careful about the downward revision of conventional wisdom about Asia. Much of the bad news is essentially cyclical, even if the cycles have been slow to turn. When the cycles eventually do turn, the prospect for an Asian century may not look quite as distant.

For example, while one can argue that some of Japan's slowdown represents a loss of technological vigor, the biggest reason for the post-1991 slowdown is simple lack of demand. In a way, Japan in the 1990s is like the United States in the 1930s: a powerful, productive economy that has stumbled into a macroeconomic muddle. Analysts such as Posen (1998) and Krugman (1998) argue that Japan currently has an output gap of more than 10 percent—that is, that output could rise by more than 10 percent if only demand were adequate. True, conventional monetary and fiscal policies have not thus far managed to close that gap; but if and when Japan does resolve the demand shortfall (perhaps by taking the advice of some foreign commentators—namely, me—that radical monetization be used to create expectations of inflation?), the resulting surge in output would make the growth record look considerably less dismal.

As for China, even though the giant nation did not share the severe downturn suffered by some of its neighbors, as long as the Asian crisis seemed to have no bottom, it was natural to suppose that China's crony capitalism would similarly come to grief one day. That may still be true: China indeed shows signs of developing a Japanese-style problem of persistent deflation and inadequate demand. But with most of Asia now growing again, and with China still managing annual growth rates of 7 percent or more, earlier projections may not be that silly after all. If China does grow 7 percent per year, while even the American New Paradigm economy manages only 3 percent, circa 2025 China will have the bigger economy.

What about the prospect that world economic leadership might shift from the

United States to Europe? This question is not simply about economic trends; indeed, it is mainly a political question. The nations of the European Union already collectively constitute an economic power comparable to the United States, and much (though not all) of the continent roughly matches the United States in terms of labor productivity and general technological sophistication. However, no individual European nation is large enough to be an economic power in the same league as the United States, or even Japan. So the question about Europe is really whether the continent can develop the cohesion and self-confidence to become an equal partner with the United States. Economic performance can play a role in the story, but more for its indirect political effects than its direct effect on the numbers.

The grand project of Europe over the past decade has, of course, been the drive for monetary union. At least some members of Europe's elite seem to have believed that monetary union would in itself radically transform Europe's economic prospects: that it would directly or indirectly help cure the continent's high unemployment rates, that the emergence of the euro as a major international currency would itself be a major economic benefit, and—always implicit in the project—that a common currency would be a step toward political union. In reality, the euro does not seem likely to do any of these things. Unemployment remains stubbornly high in the main euro-zone nations; only Britain, which has not yet decided to join, can show dramatic progress in combating “Eurosclerosis.” While the euro surely will rival the dollar as an international currency, the benefits for Europe will be modest. Some seignorage will be captured when Russian gangsters replace \$100 bills with 100-euro notes, but so what? At least so far, the prospect of a true United States of Europe seems as remote as ever.

This is not to say that Europe is any kind of economic disaster area. Unemployment, though high, has more or less stabilized; economic growth has remained reasonably high; productivity in France, western Germany, and northern Italy is comparable to U.S. levels. But anyone who expected the North Atlantic balance of power to shift substantially toward Europe as a result of economic and monetary union has been disappointed.

The upshot of all this may be summarized as follows: in terms of sheer economic weight in the world, the United States is a bit stronger than it was in 1990, thanks to faster growth here and economic crisis in Asia. The relative decline that everyone expected to continue has stopped, and even gone moderately into reverse. But while this is a significant surprise, it does not in itself explain the shift in mood from declinism to triumphalism.

Triumph of the American Model?

Those who believed, a decade ago, that the United States was in the process of losing some sort of struggle for the future did not base their views solely on the numbers. More important, they believed that the U.S. economic system had been tried and found wanting: that our *laissez-faire* economic policies and the short-

termism induced by our too-demanding financial markets left us ill-suited to the demands of modern technology and international competition. Japan not only had a better recent track record: its industrial policies, together with the long-term relationships between banks and firms that allowed those firms to engage in long-term thinking rather than focus narrowly on the short-term bottom line, would ensure that it would take the lead.

Now, of course, American triumphalists not only point to good numbers; they also stress the superiority of the American system, including its laissez-faire economic policies, and its alert financial markets that force firms to adjust rapidly to shifting markets rather than allowing them to sustain unsuccessful strategies with loans from too-friendly banks. This system, they claim, ensures that America will continue to widen its advantage.

It is at least possible that changes in the nature of technology have really reversed the rules; that assets have become liabilities, vices virtues. Perhaps Japanese institutions were perfectly tailored to the age of the fax machine, but the American way is the right one for the age of the Internet. (Moreover, this technological universe, of course, is the last word: the rules won't shift again, in a way that favors, say, Canadian values, eh?) But a more cynical view would hold that such judgements about the merits of systems are mainly *ex post facto*: knowing that America has done well the last few years, we succumb to assuming that whatever is distinctive about the American system must be superior. In either case, all we are really doing is extrapolating from recent experience—with all the pitfalls that implies.

Indeed, it would not take much to bring America's current triumphalism to an end. Let a few other countries show that they, too, can take advantage of the new technological possibilities. The most wired country in the world is currently not the United States but Finland, and video game aficionados tell us that Japan's innovative talent remains impressive. Let some countries that have experienced financial crisis stage a convincing recovery, as Korea already seems to be doing. Together with these factors, if the U.S. economy also hits a bump in the road at some point, then the case for a second American century would suddenly seem far less persuasive.

It is tantalizing to speculate about the tone of public discourse in five or ten years if those who assert that America is now a "bubble economy" like that of Japan a decade ago turn out to be right. It is very easy to imagine how, in retrospect, many economic sins that are now widely regarded as trivial—negative personal savings, a large trade deficit, the role of highly leveraged investors in our financial markets—could be reinterpreted as the American equivalent of "crony capitalism," fatal flaws that ensured the subsequent punishment.

Here is a sober view of the current and future U.S. position in the world. The truth is that the advanced nations—even Japan, once it resolves its Keynesian difficulties—have broadly converged to similar levels of technology and productivity. The United States is likely neither to fall far behind nor pull dramatically ahead of that pack, although its sheer size guarantees its place as first among equals for

many years to come. Meanwhile, the growth of developing countries will gradually erode the dominance of the advanced countries as a group, and therefore of the United States as well; but the operative word is “gradually.”

The funny thing is that a sober assessment of the prospects for U.S. leadership a decade ago would probably have reached the same conclusion. Several good years of U.S. growth and two very bad years in Asia have shifted the quantitative picture, but not the qualitative one. The old line surely applies: we were never as bad as people said, and now we aren’t as good.

Above all, it is very hard to imagine how the kind of supremacy the United States once had—when it outclassed every conceivable rival on every dimension you could think of—could ever reemerge. America will not dominate the world economy the way it used to, not because it is doing something wrong, but because many other countries are also doing something right. And that is good news for everyone.

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